Life

After Special Financial Assistance:

Shaping a Sustainable Future

by | **Gene Kalwarski**

What lessons can plans that received Special Financial Assistance (SFA) learn from their experience to avoid future funding challenges? The author suggests that improved risk assessment and actuarial reporting as well as investing in a cash flow matching bond portfolio may help plans remain solvent indefinitely.

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For years, lawmakers tried to pass legislation to address the multiemployer plan financial crisis without getting much traction. Ultimately, the COVID-19 pandemic provided the impetus—and the opportunity—for lawmakers to pass the biggest federal aid package for pension plans ever and protect the retirement benefits of as many as three million workers, retirees and their families.

On March 11, 2021, President Biden signed into law the American Rescue Plan Act, a $1.9 trillion economic stimulus package of pandemic-related provisions, which included as much as $80 billion in financial aid to rescue financially troubled multiemployer pension plans. The federal pension aid program known as Special Financial Assistance (SFA) is administered by the Pension Benefit Guaranty Corporation (PBGC). Under the program, multiemployer pension plans projected to become insolvent and plans that became insolvent after 2014 may apply to PBGC for one-time grants to stay solvent at least until 2051.

Plans do not need to repay the financial assistance but must invest most of the grant money in conservative, investment-grade fixed income securities. Pension funds that attempted to stave off insolvency by cutting benefits to participants under the Multiemployer Pension Reform Act (MPRA) will be required to retroactively restore full benefits if they are approved for SFA.

takeaways

- The Special Financial Assistance (SFA) Program will provide as much as $80 billion to financially troubled multiemployer pension plans.
- Factors including deregulation, Internal Revenue Service (IRS) tax rules and employer bankruptcies played a role in declining solvency among multiemployer plans. Plans also faced heightened investment risk because of an undue emphasis on maximizing returns, coupled with escalating negative cash flow and reporting practices that fell short of plan needs.
- Incorporating stress testing and stochastic analysis on a more frequent basis—quarterly or monthly—can provide plans with a more accurate understanding of risks and enable robust risk management strategies.
- Actuaries and trustees may benefit from embracing the Actuarial Standard of Practice #51 (ASOP 51) that encourages plans to identify, measure and assess pension plan risk.

Without the aid, PBGC estimated that more than 211 multiemployer pension plans would fail. As of October 27, 2023, PBGC had approved $53.5 billion in financial aid for plans covering about 771,000 workers, retirees and their families.

What lessons can multiemployer pension plans draw from their experience to avoid repeating the mistakes of the past? This article will explore the factors that led to the financial deterioration of these plans and suggest steps to help plans prevent underfunding in the future.

Origins of the Multiemployer Pension Plan Crisis

The financial struggles of multiemployer pension plans can be attributed to a confluence of factors, including the following.

1. **The unintended consequences of deregulation:** Deregulation in certain industries—notably trucking and communications—created significant economic pressures on both companies and labor unions that resulted in a steady decline in union membership starting in the 1980s. For example, many low-cost trucking companies started up and used nonunion labor. This drop in union membership resulted in declines in active pension plan participants and eroded a key source of funding for many pension plans. Many employers also either closed shop or went bankrupt.
2. **Internal Revenue Service (IRS) tax rules:** Before 1997, IRS rules imposed caps on tax-deductible contributions to pension plans. This prevented plans from maintaining their bargained contribution levels following years of strong investment markets and blocked them from building sufficient surplus assets to withstand subsequent market downturns. This forced many plans to declare contribution holidays or increase benefits so that current contributions could be tax-deductible. These plans could have lowered their discount rates—which are used to determine the present value of future pension benefits owed to plan participants—to deal with this issue, but few did. Lowering the discount rate increases the value of those benefits which, in turn, would increase required contributions. When the markets declined sharply in 2001 and then again during the Great Recession of 2008, many plans were left woefully underfunded. Tax rule changes in 1998 allowed more advance funding of plans, so this no longer poses a challenge.

3. **Employer bankruptcies and the "last man standing" club:** When a single employer goes bankrupt, the pension plan's unfunded liabilities largely transfer to PBGC. When participating employers in a multiemployer plan go bankrupt, the remaining employers become responsible for the unfunded pension liabilities. As this scenario repeats itself, the plan becomes the "last man standing" club, and the final remaining employer becomes responsible for the entire unfunded liability of the plan. This caused many multiemployer plans to fail as the number of employer bankruptcies increased due to deregulation and other factors.
4. **Evolving investment risk:** As pension plans matured over the years, they encountered heightened investment risk because of escalating negative cash flows, which occur when benefit payouts exceed contributions. For many plans, this negative cash flow trend started to escalate in 2000 following several years of bull markets, and then the dot-com bubble burst. Many investment consultants continued to emphasize investment performance rankings and encouraged plans to pursue risky investments to boost their standing. Moreover, actuaries were slow to lower discount rates over the past 20 years as interest rates declined steadily. This also led plans to adopt riskier asset allocations to achieve the high discount rates.
5. **Reporting practices falling short:** Reporting practices within pension plans often center on short-term investment performance, with quarterly or monthly updates being the norm. Actuarial valuation reports—crucial for assessing plan health—are issued annually, usually ten months after the end of the plan year, and often lack dynamic analysis such as stress testing and stochastic modeling. Actuarial valuation reporting practices today still look like those from 50 years ago when these annual reports consisted of comparisons of the current year's valuation results with the prior year based on a single set of best estimate assumptions. More dynamic analysis would provide future forecasts of the plan's financial condition under a variety of different economic scenarios. Plan actuaries should have taken advantage of significant information technology advancements to do more to educate plan trustees on the risks their plans face.

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Charting a Path Forward: Addressing Challenges and Reimagining Strategies

The challenges that precipitated the decline of multiemployer pension plans hold valuable insights for shaping a more sustainable future pension landscape. Industries that were deregulated suffered irreversible damage and have been reshaped completely. IRS tax rules no longer pose a challenge because of changes in the late 1990s.

There are still other issues that demand ongoing attention and innovative solutions, including:

1. **Employer bankruptcies:** The risks that multiemployer plans face due to employer bankruptcies can only be alleviated by legislative reforms, which at this point seem unlikely. One idea for reform would be to treat bankruptcies among employers in multiemployer plans the same as those in single employer plans, with the PBGC covering the loss created by the bankruptcy.
2. **Understanding investment risks and elevating reporting practices:** Pension plans should consider emphasizing comprehensive reporting on investment risk. Incorporating stress testing and stochastic analysis on a more frequent basis—quarterly or even monthly—can provide a more accurate understanding of risks and enable robust risk management strategies. Further, actuaries and trustees would benefit from embracing the Actuarial Standard of Practice No. 51 (ASOP 51), which encourages plans to identify, measure and assess pension plan risk. This ASOP became effective in late 2018. These assessments should be tailored to each plan's specific circumstances to help the trustees understand potential outcomes under varying conditions.

Case Study: “United Workers” Pension Plan

The following is an example of how one plan’s trustees focused on the plan’s greatest risks and improved reporting to help them make more effective decisions and minimize future risks. This example is based on an actual plan, but the details have been changed to preserve the plan’s identity.

United Workers is a large multiemployer pension plan with thousands of participants. Before receiving SFA, the plan was scheduled to go bankrupt within a few years even though it was fully funded 20 years ago.

Mistakes

When the plan was fully funded, it was also extremely mature, with its net cash flow—contributions less benefits and expenses—approaching 10% of assets. The plan’s actuary advised the board of trustees to consider investing in a bond portfolio with coupons and maturities that matched the plan’s net outflow for at least five years. In other words, the plan would pay out benefits with the proceeds from the bonds. With these investments—referred to as a cash flow matching portfolio—the plan could better withstand any future market downturns, since the cash flow matching would mitigate the impact of the negative cash flows.

The board accepted the actuary’s advice and implemented a five-year cash flow matching strategy. However, the plan’s investment consultant warned that such an investment strategy would result in lower investment returns. The actuary argued that the plan’s reported investment returns should exclude the return on the cash flow matching bonds because their sole purpose was to meet benefit payments. The investment consultant disagreed and, after several quarters of reporting poor returns relative to other multiemployer plans, the board terminated the cash flow matching strategy. Shortly after, the stock market plunged. The plan went into a downward spiral from which it did not recover and was scheduled to become insolvent until it received SFA.

Lessons Learned

After receiving a large infusion of money under the SFA program, the plan’s trustees needed to decide how to invest it.

SFA assets are segregated from non-SFA or legacy assets. Under the final SFA rule, funds may allocate up to 33% of the SFA money in return-seeking assets, and the remainder—at least 67%—must be allocated to investment-grade fixed income investments. The plan also needed to decide how to invest the remaining non-SFA legacy assets. There are no restrictions on how this money may be invested.

The investment consultant came up with the five asset allocation options for the SFA and non-SFA assets (Table I). For the SFA assets, Options A, B and E offer the least risk and lowest return because they are invested in a fully cash-matched portfolio, while Options C and D have the greatest risk and highest return because they include return-seeking investments in addition to fixed income. For the legacy assets, Option E offers the greatest risk and highest return, while Options A and C offer the least risk and lowest return.

The actuary then performed a deterministic analysis of these five options and arrived at the conclusions displayed in Table II. This type of analysis projects returns using an assumption that a portfolio will meet the expected return every year with no deviation. Such a projection ignores the risk of standard deviation of returns.

As seen in Table II, Option D produced the highest level of assets by 2051, and its SFA assets would last the longest, until August 2042.

As previously mentioned, this type of analysis does not provide a risk assessment based on the standard deviations (the range in which returns could

TABLE I

Asset Allocation Options for “United Workers” Pension Fund

	Special Financial Assistance Assets		Legacy Assets	
Option	Return	Standard Deviation	Return	Standard Deviation
A	4.50%	0.00%	5.58%	7.40%
B	4.50%	0.00%	7.25%	12.30%
C	5.25%	6.50%	5.58%	7.40%
D	5.25%	6.50%	7.25%	12.30%
E	4.50%	0.00%	8.20%	14.70%

fall above or below projections) shown for each portfolio. A stochastic analysis, however, can do that, and it produced probabilities of plan insolvency for many years with Option D as shown in the figure.

This enhanced analysis shows that Option E produces the lowest chance of the plan becoming insolvent in most years. While Option D produced the largest assets in 2052, the trustees elected to adopt Option E, a full cash flow matched portfolio, because by 2052 plan liabilities would be less than $400 million due to a decline in both active and retired participants. With either option, the plan is expected to be more than 200% funded.

The trustees decided that their goal of avoiding insolvency took priority over generating higher investment returns. Also, using dynamic stochastic projections instead of a static baseline projection that provides risk assessment enhanced the trustees' ability to understand the risks they faced. The static baseline projection demonstrated what the plan's assets would be if investment returns always equaled the expected return—and that never happens. So, the trustees had no way of understanding how accurate the projection was. Under a stochastic projection, the trustees could see the probability of plan insolvency under each option each year into the future.

Implementing a cash flow matching strategy becomes less attractive when interest rates decline. Trustees will have to evaluate whether a cash flow matching strategy is the best choice for their plans, and more dynamic analysis and reporting will help them determine that.

TABLE II

Deterministic Analysis of Asset Allocations for "United Workers" Pension Fund

Option	Projected 2052 Assets	Special Financial Assistance Runs Out
A	$200.7 million	August 2040
B	$574 million	August 2040
C	$371.5 million	August 2042
D	$920 million	August 2042
E	$876.3 million	August 2040

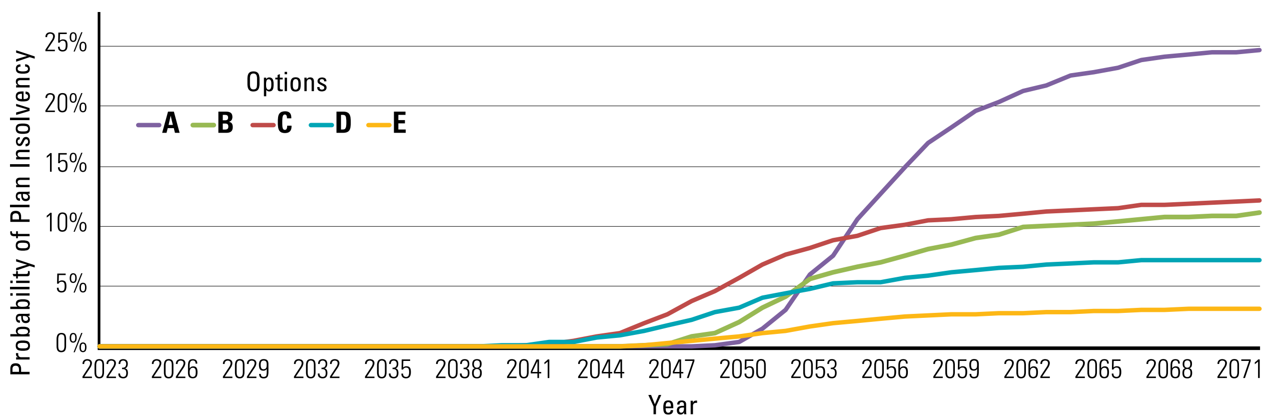
The United Workers trustees elected to invest the fund's legacy assets in the portfolio with the highest expected returns. This portfolio is also the riskiest; however, since the legacy assets are not needed for many decades—and, over time, due to reversion to the mean—the annual standard deviation risk becomes far less important. With this new investment strategy, the plan will most likely avoid insolvency and continue paying all benefits when due.

Conclusion: Forging a Resilient Pension Future

The PBGC SFA program played a pivotal role in offering a lifeline to more than 200 failing multiemployer pension plans, preventing their imminent collapse and

FIGURE

Projected Probability of Plan Insolvency by Asset Allocation Option



securing the future pensions of as many as three million participants.

Plans hoping to remain solvent after 2051 may want to explore strategies that recognize the importance of risk management and improve reporting practices. This likely holds the key to a more secure and sustainable pension landscape for all pension plans, not just those receiving SFA funds.

Plans that received SFA may consider taking these steps now:

- Work with the actuary and the investment consultant to analyze a full cash flow matching strategy with the SFA assets that matches the plan's projected benefits and expenses with interest and principal from investment-grade bonds.
- Compare the likelihood of plan insolvency under the full cash flow matching strategy with all other options offered by the investment consultant. Even though PBGC permits plans to allocate up to 33% of the financial assistance to riskier assets such as equities, which offer higher returns than fixed income, current high interest rates minimize the need for plans to do so.
- If a cash flow matching strategy is used for the SFA assets, legacy assets likely won't need to be drawn down for a decade or more so they can likely be fully invested in equities until the SFA assets are within five or so years of being depleted.

Non-SFA plans should remember that the objective of pension plans is to secure pension benefits in a cost-efficient manner with the least risk possible and not to maximize the return on assets. These plans should consider bifurcating assets into two buckets—liquidity and growth. The liquidity portfolio could consist of investment-grade bonds whose cash flows are matched to the plan's cash outflows for a period of at least five years. This would insulate the plan from the impact of negative cash flows during the period of cash flow matching. The remaining assets could go into the growth bucket consisting of equities and other riskier assets that can earn higher returns and grow unencumbered over the cash flow matching period.

Plans should then rebalance annually between the liquidity and growth buckets and replenish the cash flow matching bucket in years where the growth bucket returns exceed the plan's expectations.

bio

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